

Testimony

of

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before the

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Committee on Banking and Financial Services

on

"Financial Derivatives Supervisory Improvements Act of 1998"

and related issues

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My name is Dennis Oakley and I am a Managing Director of The Chase Manhattan Bank with responsibility for mitigation of Chase's risk in foreign exchange and derivatives markets. Chase Manhattan, with \$366 billion in assets, is the nation's largest bank holding company. I am pleased to have this opportunity to be here today to discuss new legal risk to the derivatives market raised by recent actions by the Commodities Futures Trading Commission.

Derivatives are financial contracts that allow banks, corporations and other entities to hedge various risks -- such as interest rate and currency risk, equity or commodity risk. To meet our customers' needs we are a dealer of over-the-counter derivatives, which are structured to precisely hedge those risks the customer does not wish to bear.

We hold the world's largest derivatives portfolio of FX and derivatives measured by notional principal amount, which as of March 31, 1998, stood at \$8.2 trillion. As I am sure you know, the notional principal amount, while eye-catching, is really not the right figure to look at when assessing risk. What I look at is the credit risk imbedded in the notional principal amount. At Chase the credit exposure of our portfolio is \$35.4 billion.

Because of the size and global reach of our derivatives portfolio, we are on both sides of the market. If, for example, there is an increase in U.S. dollar interest rates, we will have some customers who have derivatives contracts that will make them winners and others who will be losers. But we at Chase are in the middle, having made a market between both customers. Our gains and losses will generally offset each other.

What is our risk, then? In the example given above, our risk is that when U.S. interest rates increase, those customers who owe us money are unable to pay. For us to have a real problem, all of our customers who owe us money would have to default simultaneously. We feel confident, however, that while the portfolio is large, we have the management expertise and sophisticated systems to manage the inherent financial risk in a \$8.2 trillion portfolio. The portfolio is well diversified by every imaginable category -- geography, currency, tenor, interest rate scenario and a deep customer base. But we have no way to manage this new legal risk.

In our view, the root cause of the uncertainty created by the CFTC's actions is that the Commodities Exchange Act requires that all commodity futures contracts be traded on a board of trade, and since 1974 financial products have been considered to be commodity futures, unless they fall within the exception of the Treasury Amendment. If a product is deemed to be a future, and it is not traded on a board of trade, it is null and void. Many of the products banks sell in the OTC derivatives market perform the same risk management functions as futures.

To assure that these products are not deemed to be futures, and hence null and void, several actions have occurred. In 1989, the CFTC issued a policy statement saying that most swap transactions, although possessing elements of futures or options contracts, are not appropriately regulated as futures under the Act. In 1992, Congress gave the CFTC specific authority to exempt certain derivatives from CFTC regulation.

We have two problems with the current state of regulation. First, some of our fastest-growing products, such as equity and credit derivatives, are not covered by the

exemption. With the CFTC now raising the possibility that they are indeed futures, we have become concerned with a new level of legal risk for these non-exempted products. Furthermore, it is possible that the CFTC could change the terms of the exemption and cast doubt on the legality of our previously exempted products. Although they say they would only act prospectively, a plaintiff may argue that anything that the CFTC considers to be a future has always been a future.

Second, in order to reduce settlement risk in the foreign exchange markets, industry participants have begun to organize clearance and netting systems. Both the concept release and the CFTC's interpretation of the Treasury Amendment raise the specter that adding clearing to a previously exempt product produces a future. We are being pulled in two different directions. On the one hand, the bank regulators are demanding that we reduce the systemic risk involved in settling foreign exchange deals. And Chase has been working on a variety of proposals to create multilateral clearing and netting systems that would accomplish that goal, including the G-20 Continuous Linked Settlement Bank. On the other hand, the CFTC thinks it has jurisdiction over multilateral netting facilities, even when the product being netted is foreign exchange.

The reason I am here today is that while we are confident of our ability to manage the financial risk of derivatives, actions taken by the CFTC have brought into question our ability to manage the legal risk in one of our primary booking locations -- the United States. Chase, with a large portion of its derivatives portfolio booked in the U.S., cannot remain complacent about new risk. We owe it to our depositors and shareholders to take any necessary action to minimize risk.

Let me frank. If the legal uncertainty posed by CFTC assertions of jurisdiction is not removed, Chase will be forced to move this business to another location, probably London, where we don't have the specter of legal jeopardy that has been raised by the CFTC. A substantial portion of this business is mobile. In the case of products done with individual customers, if the customers are in the U.S. and we can't avoid the legal uncertainty by booking the business outside the U.S., we may stop doing the business with U.S. customers. That will make certain risk management products unavailable to them. In the case of clearing systems, if U.S. law makes it unattractive to locate the facilities in the U.S., we will support siting them in London and use them from our London branch.

We at Chase are pleased with the actions taken by the Chairman of the Federal Reserve, the Secretary of Treasury and the Chairman of the Securities Exchange Commission on this issue. We supported their initial expression of concern and their proposed legislation when the CFTC first issued their concept release. We especially appreciate the approach taken by you, Mr. Chairman, in H.R. 4062 and your prior efforts attempting to avoid both this hearing today and the need for any legislation through a written agreement between the appropriate federal agencies.

I understand that there are jurisdictional issues to be worked out between your committee and the House Agriculture Committee. While I am sure there are legitimate issues, as the person at Chase responsible for managing credit risk in our derivatives portfolio, I have no position on which committee should have jurisdiction, although I do know that bank derivative dealers are heavily regulated. I do, however, care a great

deal when the action of a government agency raises new legal issues which have the effect of creating new risk to our large portfolio. This is unacceptable.

It is the duty of both Congress and the federal regulators to review the structure under which products like derivatives are regulated. We at Chase believe the appropriate context is the review -- to be conducted next year -- of the CFTC's enabling act, the Commodity Exchange Act.

Markets have developed very quickly in recent years, and U.S. firms like Chase have been in the leadership. If U.S. firms are to remain in their leadership role, then we must have the regulatory climate that promotes -- not penalizes -- innovation.

As Congress undertakes its comprehensive review next year, we at Chase will weigh in with our views. We will also work closely with our trade associations like ISDA and the ABA to guide policy decisions. But between now and the conclusion of this review, the markets need the type of standstill agreement on CFTC action supported by you, Mr. Chairman, and the principal financial regulators.

I am glad to have this opportunity to provide Chase's views and would be glad to answer any questions.